Supreme Court, U.S.
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No. 96-1580

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

EDWARD A. SHAY, MARTIN L. LEHRER, RICHARD L. SMITH, ALLEN E. SHAY, and PACIFIC ARCHITECTS AND ENGINEERS, INCORPORATED,
Petitioners,

vs.

NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PETITIONER'S REPLY BRIEF

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QUESTIONS PRESENTED

1. Do ERISA plan fiduciaries who have retained a qualified independent valuation expert, and who have provided all relevant, material information and who have not provided any false or misleading information to that expert, breach their fiduciary duties by relying upon the expertise and opinions of the valuation expert?

2. Do ERISA fiduciaries breach their fiduciary duties by failing to question valuation principles developed under Revenue Ruling 59-60 which have been judicially approved and by relying on a fair market valuation which has utilized such valuation principles?

3. In an ERISA valuation of stock do the "fair market value" requirements mandated by ERISA pre-empt state law "liquidation value" methodologies contained in corporate involuntary dissolution statutes or must an ERISA fair market valuation take into consideration such state law liquidation values?

4. Can a court of appeals reverse a trial court's decision that ERISA fiduciaries did not breach their fiduciary duties with respect to the sale of stock without reversing the trial court's findings of fact that the fiduciaries properly selected a qualified, independent valuation expert, that the fiduciaries provided all relevant, material information and no false or misleading information to the expert, and that the sale price was for fair market value, and without concluding that any of the trial court's findings of fact was clearly erroneous?

RULE 29.6 STATEMENT/PARTIES TO PROCEEDING

All parties in this Court appear in the caption of the case.

Pursuant to Rule 29.6, the Court is advised that petitioner Pacific Architects and Engineers, Incorporated is a closely-held company with no parent company, and no publicly traded stock. Other than wholly-owned subsidiaries, petitioner's only subsidiaries are The 1216 Corporation, PAE (New Zealand) Limited, PAE Bumi Berlian SDN BHD, K.K. Halifax Associates, Nus Antara Pacific Limited, JINDO-PAE Limited, P.T. Paranada Ekayasa, Pacific Architects and Engineers Company Limited, PAE-Middle East, Pacific Services Company Limited, and Far East Equipment Leasing Limited. None of the petitioner's non-wholly owned subsidiaries has issued stock to the public.

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I. The Ninth Circuit reversed the trial court's decision by introducing a wholly new standard of conduct for ERISA fiduciaries which is in conflict with the standard set forth by the Fifth and Seventh Circuits.

In order to avoid the conflict between the Ninth Circuit's decision in this case and the decisions of the Fifth and Seventh Circuits, Respondents assert that the Court of Appeals in this case merely "found as a matter of law that an improper standard was utilized by the trial court." Respondents' Opposition, p. 24. To the contrary, the Court of Appeals expressly stated that it did not base its opinion on whether the trial court utilized the proper standard. Instead the Court stated that, "we reverse on the grounds that even if the district court applied the prudent man standard, it did not apply it correctly." App. at A9.[1]

It is well-settled that an ERISA fiduciary must seek independent expert advice when the fiduciary lacks the requisite expertise, skill, or knowledge. *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir.), *cert. denied*, 469 U.S. 1072 (1984); *Donovan v. Bierwirth*, 680 F.2d 263, 272-273 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982); *Donovan v. Walton*,

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[1]Respondents take out of context the trial court's "business judgment rule" language and distort its meaning. The trial court, as part of its analysis of whether the ESOP received "fair market value determined in good faith" addressed the fiduciary's business judgment which has been recognized as a necessary component of the "good faith" element required by ERISA § 1002(18)(B). *Donovan v. Cunningham*, 716 F.2d 1455, 1468 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984); Proposed 29 C.F.R. § 2510(b)(3)(ii) (53 Fed. Reg. 17632).

609 F.Supp. 1221, 1240 (D.C. Fla. 1985), *aff'd sub. nom., Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986); 26 U.S.C. 401(a)(28)(C). Petitioner's first question presented raises the issue of then and under what circumstances an ERISA fiduciary can rely on that expert's advice.

The Ninth Circuit sets forth a new and extremely strict standard; one that very few ERISA fiduciaries could satisfy. It concludes that an ERISA fiduciary must be sufficiently knowledgeable with valuation techniques to review and question the methodology employed by the valuation expert and then, if there are any uncertainties, the fiduciary must retain at least a second valuation expert. App. at A11, A13. In direct conflict, the Fifth Circuit found that "ERISA fiduciaries need not become experts -- they are entitled to rely on the expertise of others" as long as the fiduciaries ensure that the valuation experts utilize complete and up-to-date information. *Cunningham, supra*, 716 F.2d at 1468. At the trial level, the District Court followed the Fifth Circuit's interpretation and application of ERISA's requirements, and yet this decision was reversed by the Ninth Circuit.

The Ninth Circuit's opinion does not simply reverse a trial court's erroneous choice of law as Respondents claim. Instead, the Court's decision fundamentally alters the standard of conduct required by ERISA fiduciaries, and the level of expertise which ERISA requires a fiduciary to possess, and is in direct conflict with the Fifth and Seventh Circuits' interpretation of ERISA's requirements. As Justice O'Scannlain noted in dissent, "I know of no case in which ERISA fiduciaries were adjudged to have breached their duty when they carefully selected and accurately informed the independent appraiser of the relevant data." App. at A12. The Ninth Circuit's decision in this case does just this.

II. The liquidation valuation methodologies of California's involuntary corporate dissolution statute, Cal. Corp. Code §1800, *et seq.*, may not be saved from preemption by ERISA under ERISA's "savings clause" for state statutes that regulate securities.

ERISA Section 2(18)(B) mandates that the value of a plan's assets must be determined by conducting valuation based on the assets' fair market value. 29 U.S.C. § 1002(18)(B). Further, this Court has consistently held that ERISA's preemption provisions create one of, if not the most, expansive preemption standards known to law. *California Division of Labor Standards Enforcement v. Dillingham Construction*, 65 U.S.L.W. 4097 (February 18, 1997) (see cases cited therein). Consequently, a state involuntary corporate dissolution statute which mandates that value be determined pursuant to a liquidation valuation must be preempted by ERISA's express fair market value requirements when conducting a valuation for ERISA purposes. The decisions of this Court, as well as the decisions of the Fifth and Eighth Circuits, require such a result. Consequently, the Ninth Circuit's decision in this case is in conflict with these decisions.

Respondents attempt to fundamentally change the Court of Appeals decision by stating (without citation) that "relegated to a footnote was the circuit court's dismissal of petitioners' contention that ERISA preempts state securities laws (here, Cal. Corp. Code § 1800), citing *Aloha Airlines, Inc. v. Ahue,* 12 F.3d 1498 (9th Cir. 1993)." Respondents' Brief, p. 19. Although the Respondents are correct that the Ninth Circuit's analysis of ERISA's preemption provision was primarily contained in a footnote, Respondents also attempt to transform the Ninth Circuit's decision into a decision based on ERISA's "savings clause" for state laws

which regulate securities.[2] However, Cal. Corp. Code § 1800 does not regulate securities, nor did the Court of Appeals base its decision on this ground.

California has a completely separate and distinct statutory framework that governs and regulates corporate securities under the Corporate Securities Law of 1968, Cal. Corp. Code §§ 25000, *et seq*. In contrast to the Corporate Securities Law of 1968, Cal. Corp. Code §1800 is an involuntary dissolution statute which sets forth the grounds which a corporation may involuntarily be forced in to dissolution, and how the assets of the corporation must be valued for dissolution purposes.[3]

The Sixth Circuit rejected arguments very similar to Respondents'. In *Michigan Carpenters Council v. C.J. Rogers, Inc.*, 933 F.2d 376 (6th Cir.), *cert. denied,* 502 U.S. 982 (1991), the Sixth Circuit addressed whether Michigan's corporate reorganization statute was preempted by ERISA,

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[2]ERISA's preemption "savings clause", 29 U.S.C. § 1144(b)(2)(A), provides: "Except as provided in subparagraph (B), nothing in this subchapter shall be construed to exempt or relieve any person from any law of any State which regulates insurance, banking, or securities."

[3]Respondents' claim that *Stumpf v. C.E. Stumpf & Sons, Inc.*, 47 Cal.App.3d 230 (1975), stands for the proposition that no grounds are required to invoke Cal. Corp. Code §1800 has no merit. In *Stumpf* the California Court of Appeals found that:

> "the procedure created by the statute does not authorize dissolution at will. The minority must persuade the court that fairness requires drastic relief under section 4651, subdivision (f) [the predecessor statute to Section 1800(b)(5)]; involuntary dissolution is not an automatic remedy but, rather, a matter for the court's discretion." *Id.* at 235.

and whether the statute "regulated securities" as defined by ERISA's preemption "savings clause," 29 U.S.C. § 1144(b)(2)(A). The Sixth Circuit noted that Michigan has a separate and distinct state securities act and that the reorganization statute concerned general corporate governance, not the regulation of securities. *Id.*, at 384. Thus, the Michigan corporate reorganization statute did not fall within ERISA's "savings clause." As a result, unlike the Ninth Circuit in this case, the Sixth Circuit found that the Michigan reorganization statute was preempted by ERISA to the extent it interfered with the calculation of benefits, disbursement and availability of funds. *Id.*, at 383.[4]

Furthermore, the Ninth Circuit's opinion does not even base its conclusions on ERISA's savings clause for securities regulations, 29 U.S.C. § 1144(b)(2)(A). The Court of Appeals decision does not even make reference to ERISA's savings clause, nor in any way characterize Section 1800 as a securities regulation. Indeed, the case law cited by the Ninth Circuit, *Aloha Airlines v. Ahue,* 12 F.3d 1498 (9th Cir. 1993), does not even concern ERISA's "savings clause" provision for state statutes which regulate securities. Consequently, Respondents' attempt to buttress the Ninth Circuit's legal conclusion that ERISA's fair market value

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[4]Respondents, as well as the Ninth Circuit, seem to view ERISA preemption as an all or nothing issue. However, many courts have recognized that a state statute may be preempted only to the extent that the state statute may be used to effect change in the administration, structure and benefits of an ERISA plan. *See, e.g. National Elevator Indus., Inc. v. Calhoon*, 957 F.2d 1555, 1561 (10th Cir.), *cert. denied*, 506 U.S. 953, 113 S.Ct. 406 (1992); *Michigan Carpenters, supra*, 933 F.2d, at 382-383. Requiring liquidation value under Cal. Corp Code § 1800, *et seq.* to be incorporated into ERISA's fair market value requirements would do exactly this.

requirements do not preempt Cal. Corp. Code § 1800's liquidation valuation procedures based upon ERISA's securities laws savings clause is without any basis.

III. Review of the Ninth Circuit's application of the fundamental principles of valuation and of Federal Rule of Civil Procedure 52(b) is both necessary and proper by this Court because the Ninth Circuit's decision creates conflict with other Circuit Court decisions.

Contrary to Respondents' assertion that the Ninth Circuit "had no occasion to determine whether or not the valuation was correct," (Respondents' Opposition, p. 24), the Court's decision was premised on its attack of Arthur Young's valuation methodology. Respondents' claim to the contrary is disingenuous. The Court of Appeals sets forth what it perceived to be the problems with Arthur Young's valuation methodology by requiring the fiduciaries to question and challenge the problems that it perceived. The standard to which the Court held the fiduciaries is inextricably intertwined with the valuation methodology utilized by Arthur Young which the Court concluded should have been questioned by the fiduciaries.

In this manner, the Court of Appeals challenged three key aspects of Arthur Young's valuation methodology: the size of the minority discount, the liquidity discount, and the marketability discount that were applied by Arthur Young (App. at A9-A11).[5]

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[5]The Court of Appeals states, with regard to the liquidity discount, "[a]lthough it gave reasons for deviating from the average, Arthur Young did not explain why these reasons resulted in an increase of fifteen percentage points as opposed to some lesser amount." App. at A10. With regard to the minority

The Court of Appeals squarely addresses the factual basis for the District Court's decision, yet never addresses whether any of the District Court's findings of fact were clearly erroneous. Additionally, the Court of Appeals addresses neither the evidence presented at trial, nor gives any credence to the trial court's assessment of the credibility of the witnesses presented at trial.[6] Further, almost every case which has addressed issues of valuation has found that the value of stock is a question of fact, to be reviewed under a clearly erroneous standard. Respondents' citations to cases involving appellate review of preemption issues is misplaced. The issue presented to this Court regarding the proper standard of review involves the valuation of the stock, not preemption.

IV. The standard of review utilized by the Ninth Circuit directly conflicts with decisions of the Fifth and Seventh Circuits.

Again, to avoid the conflict created by the Ninth

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discount, the Court stated that Arthur Young applied the discount, "without providing any empirical support for a 60% discount or giving any explanation as to why it increased this discount factor twenty percentage points since its May valuation." Id.

[6]The District Court expressly rejected the Plaintiffs/Respondents' arguments concerning Arthur Young's valuation because, as the District Court found:

> "At trial, defendants' witnesses, both percipient and expert, clearly articulated the propriety and reasoning for each of the discounts taken. Plaintiff's experts on the other hand were not able to articulate any logical or legal reason for disallowing the discounts taken by Arthur Young & Company." App. at E11.

Circuit's decision with the Fifth and Seventh Circuits concerning the proper standard of review for questions of the value of closely-held corporate stock, Respondents attempt to buttress the Ninth Circuit's decision by supplementing the Court's reasoning and by asserting facts that are contrary to the record and in conflict with the findings of fact of the District Court -- findings not reversed by the Court of Appeals.

Respondents assert that "[b]y application of the law to the proper standard of review, the Ninth Circuit came to the correct conclusion, overturning the erroneous findings of the district court." Respondents' Opposition, p. 25. Quite to the contrary, the Court of Appeals never states the standard of review it has utilized. Additionally, the Court of Appeals neither reverses nor finds clearly erroneous any of the District Court's findings of fact.

Nevertheless, Respondents continue to attempt to reargue the facts of this case in direct conflict with the District Court's findings. For example, Respondents contend that the main purpose of the 1988 stock sale was for estate planning purposes.[7] However, the District Court expressly found that the "continued liquidity of the ESOP and the possible future inability to purchase shares from plan participants and beneficiaries were the prime reasons the plan fiduciaries voted to sell the PAE stock to the E. & A. Shay Irrevocable Trust on November 9, 1988." App. at D7.

The District Court also expressly found that the fiduciaries properly retained Arthur Young. App. at D5. Respondents attempt to characterize the fiduciaries search as somehow tainted. Yet, the District Court found that

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[7]Respondents state, "The district court record reveals that the purpose of the termination of the ESOP was part of Shay's estate planning for his son, co-defendant, Allen Shay (Ex. 31; 47, 50; RT: IV:58:8-59:17)."

"[f]ollowing extensive interviews of major valuation firms, Arthur Young & Company was retained by the administrative committee of PAE ESOP. . ." and that the fiduciaries "provided all relevant, material information to Arthur Young & Company regarding the ESOP and PAE's assets and operations and did not provide any false or misleading information to Arthur Young & Company. App. at D5.[8]

Additionally, Respondents assert that Arthur Young & Company relied on PAE's attorney and that regular counsel to the ESOP was never even consulted on the issue of whether there were grounds to invoke Cal. Corp. Code § 1800. Respondent's Opposition, p. 4-5. To the contrary, the ESOP's regular counsel, Ronald Ludwig, as well as PAE's corporate attorney, Carol May, both testified that Mr. Ludwig was consulted and that he was satisfied that the ESOP had no grounds to commence involuntary dissolution proceedings against PAE. *See* IX/109:12-13; XVI/29:18-30:17, 53:21-54:9.[9] Since the Court of Appeals did not reverse any of the

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[8]Moreover, the record in this case does not support Respondents' charge that the fiduciaries decided in advance to accept a predetermined appraisal. Respondents' Opposition, p. 2. At trial, Petitioner Richard Smith testified that the fiduciaries did not set a certain price. XVII:153:4-8. Additionally, Smith testified that he had received a preliminary valuation figure from Arthur Young and Company in October 1988 which was lower than the eventual sale price and he refused to even consider the sale at this price because he felt that it was too low. XVII:154:23-155:24.

[9]Indeed even the portion of the transcript immediately preceding the portion cited by Respondents evidences Mr. Ludwig was consulted. *See* II:128:13-19 ("Q [by Mr. Kolts]: Had you discussed that subject matter with anyone before receipt of this letter? A [by Mr. Lehrer]: There had been some previous discussion on this, and it was the opinion of the administrator, Mr. Smith, and the counsel for the ESOP, Mr. Ron Ludwig, that there

District Court's findings of fact, this Court should not countenance Respondents' attempts to distort the facts at this stage.

V. CONCLUSION

For all of the foregoing reasons, the petition should be granted.

DATED: April 25, 1997

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were no facts that would provide grounds for involuntary dissolution.")